

TERMINATION AND COMPENSATION PROVISIONS FOR A BOT ROAD PROJECT

Authors: Azeem Tahir, Ijaz Ahmed, Noboru Kondo

ABSTRACT

The key feature of the BOT road model is the granting of a concession to a project company who shall assume responsibility for design, finance, construction and operation of a road project for the duration of the Concession period. BOT projects offer many advantages to the government, but at the same time they are complex from both financial and legal points of view. Most often provisions of a project agreement are negotiable contract terms despite the fact that there is always a baseline standard project agreement. It is experienced that negotiation on termination and its compensation clauses is quite laborious for both parties. Events leading to termination must be avoided and there must be safety valves built into the project agreement that provide for alternate mechanism and respite to the grieved party. This Paper discusses the mechanism for working out the compensation related to default by the project company, government or force majeure. The compensation of termination is worked out depending upon the stage of project viz before financial close, during construction, after construction etc. This paper details the underlying factors for working out fair and equitable mechanism acceptable to both Government and the project company.

INTRODUCTION TO BOT

BOT is the terminology for a model or structure that uses private investment to undertake the infrastructure development. In a BOT project, a private company is given a concession to build and operate a facility that would normally be built and operated by the government. The private company is also responsible for financing and designing the project. At the end of project agreement, the private company returns ownership of the project to the government. The concession period is determined primarily by the length of time needed for the facility's revenue stream to pay off the company's debt and provide a reasonable rate of return for its efforts, risk and investment.

BOT projects offer many advantages to the government, but at the same time they are complex from both financial and legal points of view. The Project agreement is the principal contract governing a BOT project. Most often provisions of a project agreement are negotiable contract terms despite the fact that there is always a baseline standard project agreement. It is experienced that negotiation on termination and its compensation clauses is quite laborious for both parties as it is very critical and huge financial effects are associated with these clauses.

BOT FINANCING

Financing or capital is required for the implementation of all projects. BOT schemes are in large part a means for a government to mobilize private financing for infrastructure projects. Broadly speaking, there are two types of capital available to all projects: equity and debt. Each plays a specific role in project financing and has its own risk characteristics.

Equity is the lowest ranking capital of all in terms of its claims on the assets of a project. It represents the funds injected by the owners of the project. Normally all other project obligations must be satisfied before any distributions can be made to equity investors. If a project fails, therefore, all other claims must be met before any claims can be made by equity investors. Moreover, if after all other obligations are met, the value of the remaining assets is less than the initial equity capital of the project, the investors will bear the loss. Equity investors therefore bear a higher degree of risk than any other providers of capital. For this reason, equity capital is also referred to as risk capital. However, if a project proves to be highly successful, then the residual value of assets, after all other obligations are met, will certainly exceed the initial equity capital of the project. This surplus will accrue entirely to the providers of equity capital in the form of capital gains. Thus while equity investors bear the highest risk, they also stand to make the biggest gains if a project is successful.

On the contrary, a project's senior debt has the highest ranking of all capital. Senior debt has first claim over all the assets of a project and must be repaid first, according to a predetermined schedule. Only after the claims of senior debt are satisfied can the claims of others be considered. As such, the senior debt bears the lowest risk of all capital.

PROJECT AGREEMENT

The project agreement (also called a concession agreement) is a heart of all BOT projects. It defines the rights and obligations of the project company and the host government for the development and operation of the project. It gives the project sponsors the right and obligation to finance, construct and operate the project for a specified period. It allocates project risks initially between the project sponsors and the government. The project agreement is at the centre of the web of contractual arrangements which, taken together, define the BOT project.

The project agreement stipulates the tariffs and terms of payment under various conditions and defines the performance standards to be met by the project company in the construction, operation and maintenance of the project in question. It specifies the support to be provided by the government, the supervision mechanism required by the government and the actions to be taken if certain eventualities occur during the life of the project. Finally, the project agreement stipulates the terms of the transfer of the project at the end of the concession period.

GENERAL OBLIGATIONS

The provisions in a project agreement that must be observed during all phases of the implementation of a BOT project may be organized in three broad sections. Firstly, there are government obligations such as assistance in obtaining permits, tax and duty incentives,

safety and security protection etc. Then the private party requires assurance from the government in case of change in law and protection from competition. Secondly there are obligations of the project company such as compliance with laws of the host country, environmental protection, safety standards, use of national contractors, technology transfer etc. Finally, there are common obligations like confidentiality of information, warranty against improper payment etc.

BREACH OF CONTRACT

Strict adherence to contract terms relating to the performance of obligations is particularly important in BOT arrangements, as a failure by one party to adhere to the contract terms might have serious financial consequences for the other party and for the lenders. It is therefore advisable to prepare and agree upon precise stipulations in the project agreement defining the obligations to be performed and the consequences of a failure to perform those obligations. Most notable breaches are highlighted as under:

Breach by the project company

- (i) The Project company fails to achieve Financial Close in accordance with the provisions of Project agreement.
- (ii) The Project company fails to achieve any Project milestone and fails to cure such default within stipulated period.
- (iii) The shareholding of the Consortium Members falls below the minimum prescribed under Project agreement;
- (iv) A resolution is passed by the shareholders of the Project company for the voluntary winding up of the Project company;
- (v) The Project company is adjudged bankrupt or insolvent or if a trustee or receiver is appointed for the Project company or for any of its property that has a material bearing on the Project;
- (vi) An event of default of the Project company under any of the Financing Documents has occurred or any of the Senior Lenders has recalled its loan under any of the Financing Documents;

Breach by the government

- (i) The government repudiates this agreement or otherwise evidences an irrevocable intention not to be bound by this Agreement.
- (ii) The government or any government agency have by an act of commission or omission created circumstances that have a material adverse effect on the performance of its obligations by the Project company and have failed to cure the same within stipulated period.
- (iii) The government has delayed any payment that has fallen due under this agreement if such delay exceeds stipulated period.

Force Majeure:

Force Majeure means an event which is not caused by and is beyond the reasonable control of either party and whose occurrence could not have been reasonable foreseen. It includes such events like war, riots, act of terrorism, unusual flood, major earthquake etc, or any Act of God.

TERMINATION COMPENSATION

The amount of compensation payable on termination is one of the key commercial issues for all parties concerned. The question which is then relevant is how best to assess, what is an appropriate level of compensation for private party Default or an Institution default. The value of compensation payable to the Private Party on an early termination will vary depending on the timing. The concession period (usually 25 years) can be broken down into following distinct periods:

- i. Financial Close period (usually 0.5 year)
- ii. Construction Period (usually 2.5 years after financial close)
- iii. Debt servicing (usually 10 years after financial close)
- iv. Operations Period (usually 24.5 year after financial close)

Where the termination is a result of Institution Default, the value of the compensation payable to the Private Party is usually greater than that payable in the event of Force Majeure termination or termination as a result of a Private Party Default. The compensation payable on Private Party Default should be substantially less than the compensation payment on termination for any other reason. One question that may be asked is why compensation should be paid to the Private Party, when it has defaulted. Under a typical service contract, not only would no compensation be paid but the defaulting party could also expect the other party to bring claims for damages. The reason that compensation is paid is that a failure to compensate could unfairly benefit the Institution. This would be the case, for example, where a particular asset is developed to deliver the Services and the Institution is entitled to have the asset transferred to it on a termination without compensating the Private Party for its value.

COMPENSATION CALCULATION LOGIC BASED ON RETURN ON EQUITY APPROACH

It has been observed that discussion on compensation mechanism during negotiations on Concession Agreement is quite cumbersome. Both parties try to ensure that they fully understand the legal language and comprehend the consequences while safeguarding their interests. However, the legal-financial language drafted by lawyers is so verbose that full comprehension by stakeholders involved is difficult.

This Paper presents an alternate mechanism whereby the compensation is numerically calculated and is calculated in numbers or a percentage of equity at the onset. Basic theme of this calculation is that the concessionaire puts into the project his equity. He then expects to gain certain return on this equity after number of years i.e the concession period. The basic question is if the concession agreement is terminated early what return on concessionaire's equity is he eligible for. Say if the concession agreement is terminated in the tenth year while the concession period is 25 years and the envisaged return after 25 years is 20%, what should be the justifiable return upon termination? Surely it can not be 20%, otherwise there will be an incentive to terminate the agreement. The purpose is to allow the Shareholders to take the full benefit of good Private Party performance but bear

the risks associated with poor performance. The Institution would pay an amount of Equity based on their financing rate.

Compensation amount is proposed to be calculated based on Return on equity. The purpose is to provide the Shareholders with the returns they expected from the Project at the outset, regardless of actual project performance (whether better or worse than expected). The compensation payment is the amount which, when taken together with all amounts already paid in respect of Equity (by way of dividends and other distributions) and taking into account the actual timing of all such payments, provides the Shareholders with their base case return on equity as agreed at the Signature Date. Where the base case return on equity has already been achieved, no payment should be made; compensation to reflect the base case return on equity for the remainder of the Project Term.

It is logical that the compensation amount to the concessionaire shall be the highest in case of default by government and lowest in case of concessionaire default; while it will be in the middle in case of force majeure.

The proposed rate of return approach described below represents a balance between protecting the Institution's interests and not imposing unreasonable penalties on the Private Party for its default. The possible extremes boundaries of compensation Financial Internal Rate of Return (FIRR) can be defined based on the reason of termination:

- Institution Default : FIRR = Between Financing Rate and FIRR of Company
- Company Default : FIRR = less then the Financing Rate
- Force Majeore: FIRR = In between the above two.

COMPENSATION CALCULATION ON A HYPOTHETICAL CASE

The calculation of compensation can be undertaken at different stages. At feasibility stage it is needed to become a part of the draft concession agreement. At negotiation stage it is needed to firm up the number or a percentage. Under the scope of this paper a hypothetical case was taken and was evaluated at the feasibility stage. The returns on X motorway project with a project cost of Pak Rs 11 Billion were taken. The amount of investment to be made from equity is Pak Rs 3.4 Billion and the balance is to be raised from the commercial bank borrowing with a financing rate of 13%. The following table depicts the amount of equity investment in the construction period and the returns in the operation period:

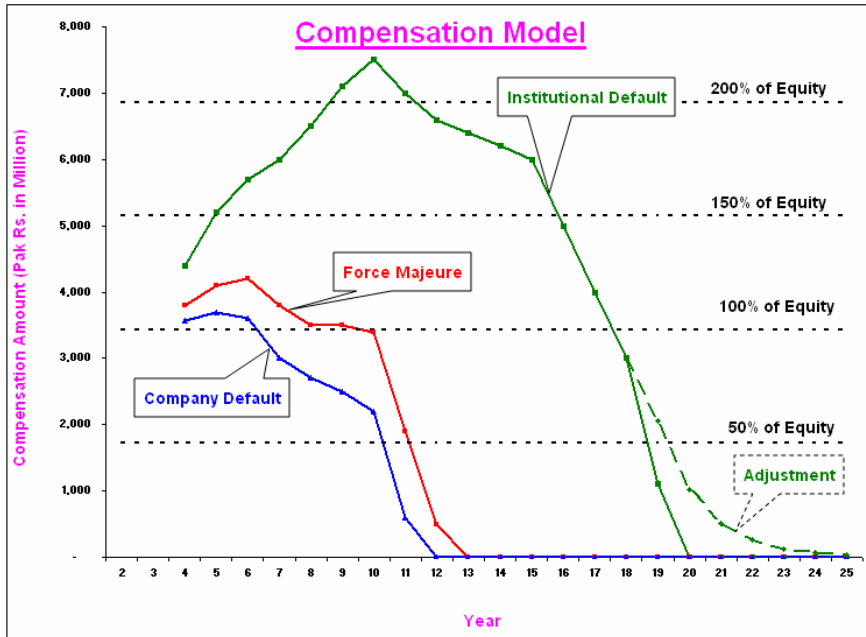
Phase	Year	Equity/ Returns (Pak Rs)	FIRR (%)
Construction	1	-686.16	
	2	-1372	0%
	3	-1372	0%
Operation	4	-81	0%
	5	229	0%
	6	593	0%
	7	363	0%
	8	327	0%
	9	349	0%
	10	1631	-0.1%
	11	1462	5.2%
	12	511	6.5%
	13	567	7.6%
	14	1610	10.1%
	15	1730	11.9%
	16	1860	13.2%
	17	2002	14.3%
	18	2156	15.2%
	19	1075	15.5%
	20	1196	15.8%
	21	1331	16.1%
	22	2929	16.6%
	23	3167	17.0%
	24	3428	17.3%
	25	5285	17.7%

The compensation is then calculated for a specific year for the following three causes of termination and applying the FIRR as indicated:

- Institution Default : FIRR = 15 %
- Company Default : FIRR = 2%
- Force Majeure: FIRR = 6%

The compensation amount is calculated for a specific year as the balance amount in that year needed to make the FIRR equals to the above percentages. The compensation amounts are plotted for the three categories of termination, whereby the highest curve relates to institution event of default while that at the bottom relates to concessionaire default. The curve in the middle represents force majeure. The graph is also compared with the percentage of equity. The compensation amount in any year can be sorted using the same graph. For example if the concession agreement is terminated due to Institution default in the year 10 then the institution has to pay to the company Pak Rs 7.3 billion (about 220% of his equity) whereby if it is terminated on company's default then the institution will pay to the company about Pak Rs 2.1 Billion (about 60% of his equity). In case of institution default whereby the FIRR is 15% some adjustment is also to be made so the company be compensated something in the end years to cater for the termination and other expenses. The above amounts are exclusive of debt liability which is to be taken by the institution or be mitigated through step in or substitution arrangements.

The following graph gives the details of compensation amounts w.r.t the operation years.



CONCLUSION

This Paper has demonstrated a practical way for calculating termination compensation during operation period. The compensation during the construction phase could be:

- the actual investment made with certain interest usually CPI in case of Institution default
- Reduction in the actual investment made with certain deductions usually percentage in case of company default

This comprehension can help in drafting compensation clauses in a simple and well-understood manner. Further scope of research can be in carrying out simulation analysis using Monte Carlo technique to assess the probability of each event.